THE EXTERNAL ENVIRONMENT

Global economic development is moving in a divergent path. Robust GDP growth in Europe and North America continues to contrast deepening recession in the emerging markets and Japan. Historically low interest rates in the OECD countries are countered by severe credit crunch in most of East Asia. Stable consumer prices in industrial economies are contrasted with rising inflation in many of the crisis-ridden Asian countries, while buoyant asset prices in Europe and the US accompany growing volatility of the major emerging markets.

It remains unclear to what extent deepening crises in East Asia and growing volatility of emerging markets will unseat robust expansion in the West. On the other hand, it is equally uncertain if sustained growth in Europe and the US will pull Asia out of its current doldrums and stabilize emerging markets from Russia to South Africa. International efforts to coordinate policies and reinforce market stability are yet to yield desired results.

In the US, despite sharply lower GDP growth in Q2 1998, domestic demand continued to power ahead at an annualised 6.9% growth rate. Improving employment picture and external payments position also buoyed German growth prospects, fueling the Euro-phoria among the EMU members.

In East Asia, however, almost all economies witnessed sharply slower or negative growth. Japan's economic recession and a weakening yen have added to the uncertainties as to when financial stability can finally be restored in Asia

The growth of the mainland economy moderated in the second quarter of 1998 amidst slow consumption demand and volatile external sector developments. The heavy flooding of the Yangtze River has impeded growth in the second quarter and the damage may intensify in the third quarter. Government policies to stimulate investment started to bear fruit as investment in priority sectors surged substantially. Efforts to accelerate restructuring of the state sector and further liberalisation of foreign investment, especially in the services sectors, would provide ample opportunities for the Hong Kong economy.

Economic Activity

With the exception of Japan, economic activity in the industrial world has remained buoyant over the past quarter. In the US, the sharply lower 1.4% GDP growth in Q2 1998 (as compared with 5.5% in Q1), was mainly attributed to temporary factors including the strike in General Motors and a reduction in inventory buildup. However, underlying growth momentum of the economy remained strong, as indicated by a 6.9% jump in domestic demand during the quarter. Looking forward, the major uncertainty lies in the external sector, where falling exports to Asia and strong imports slashed GDP growth by 3% in Q2 98.

Continental Europe's recovery is gathering pace. Real GDP growth of the Euro area reached 2.6% in Q1 98 (up from a 1.8% in the previous quarter) and industrial output rose by a year-on-year 5% in May. Germany saw improvements in its labour market and external accounts, two critical areas of structural adjustment. The unemployment rate fell to 11% in June and the current account registered its third consecutive monthly surplus in May. Output growth in the UK and Canada moderated with higher interest rates and slower trade expansion, but stayed at a relatively solid 3-3.5% range.

In sharp contrast, the Japanese economy skidded into recession, the first time since FY1974/75. Real GDP contracted by 1.3% in Q1 1998 and 0.7% in FY1997/98. Despite a ¥2-trillion tax cut introduced in April and near-zero interest rates, there are few signs of demand recovery. Retail sales dropped 3.7% year-on-year in June, the unemployment rate shot up to a record 4.3% in the same month, and industrial output fell 8.5% in Q2. Since last October, the Hashimoto government came up with five packages to stimulate demand and stabilize the financial system, including a ¥16.65 trillion fiscal stimulus package and a bridge bank scheme. The new government led by Obuchi pledged to cut tax permanently by over ¥6 trillion. It is hoped that with the new package, the new government could restore market confidence.

Meanwhile, Asia went through its worst slump ever. Almost all East Asian economies suffered from weaker or negative growth in the past two quarters, with only patchy signs of recovery. Elsewhere, output growth in major Latin American countries also moderated, and more emerging market economies like Russia and South Africa were beset by financial stresses. An emergency US$11.2 billion IMF package has managed to restore some stability in Russia.

The sharp contrast between the non-Japan industrial economies and the developing world is a concern. Reduced demand from Asia has already slowed export growth in the US, contributing to the widening trade deficit. However, it is uncertain to what extent crises in East Asia and volatility of some major emerging markets will dampen robust growth in the West. Nor is it clear if sustained growth in Europe and the US could pull Asia out of its current doldrums and restore stability in other emerging market economies. International efforts aimed at coordinating policies and restoring market stability are yet to yield concrete improvements.

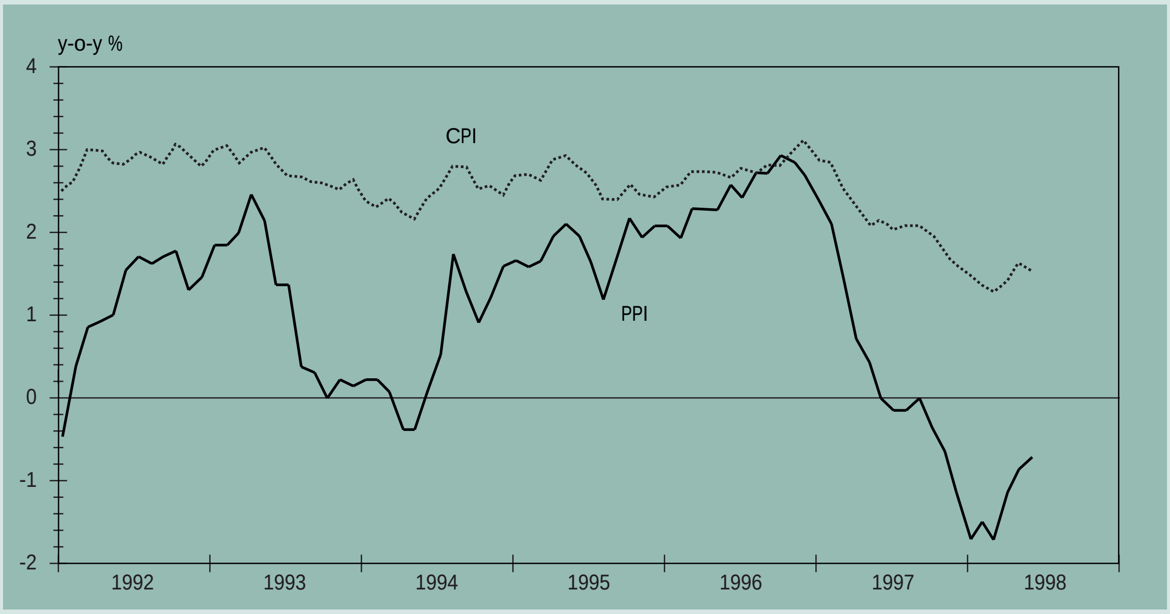
Inflation

Inflation in the industrial economies remains subdued. Stable commodity prices, strong output growth and cheap supplies from areas like Asia have kept global inflation in check. Oil prices are at record lows. However, there are some early signs that disinflation is moderating in the US. After decelerating for more than a year, CPI inflation rebounded marginally by a year-on-year 1.6% in June. The PPI also reduced its decline to 0.8% in the same month (Chart 1). A tight labour market is putting pressure on wages, with the employment cost index rising at a faster pace from 3.3% in Q1 1998 to 3.5% in Q2.

In the Euro area, consumer price inflation eased from a year-on-year 1.5% in April to 1.3% in May. The German cost of living index rose 1.2% in June (down from 1.8% at end-1997), while producer prices dropped a month-on-month 0.1% in May, the second consecutive monthly decline.

In Japan, sluggish demand has depressed prices. Wholesale prices continued to fall in June, albeit at a decreasing rate, while consumer prices increased only marginally by 0.1%.

Chart 1
US Inflation



Monetary Policy

Credit crunch in many Asian and other emerging market economies were contrasted by generally buoyant liquidity environment in the industrial world. Interest rates in the latter were kept at historic low levels. The US Federal Reserve has left interest rates unchanged since March 1997. However, the Fed has adopted a tightening bias since March 1998 and has repeatedly warned against the risk of higher wages and exuberant asset price inflation. In his latest semi-annual Humphrey-Hawkins testimony, Fed Chairman Alan Greenspan warned that stock prices were too high and a sharp stock market drop is inevitable at some point.

In Germany, subdued inflationary pressure has thus far allowed the Bundesbank to adopt a relatively accommodative stance. Bundesbank President Tietmeyer's remark that he expected the EMU to start at interest rates close to Germany's current 3.3% repo rate seemed to have reinforced market expectation that an imminent Bundesbank tightening is unlikely. A 25-basis-point hike in UK base rate in early June signaled the Bank of England's concern over the country's tight labor market. While UK monetary policy may remain tight and further hike in interest rates cannot be ruled out, it is unlikely to divert the monetary stance of Continental Europe.

The Japanese official discount rate has been kept unchanged at the historic low level of 0.5%. With discount rate at such a low level, the room for and effectiveness of further downward movement is limited, despite calls to reflate the economy more aggressively.

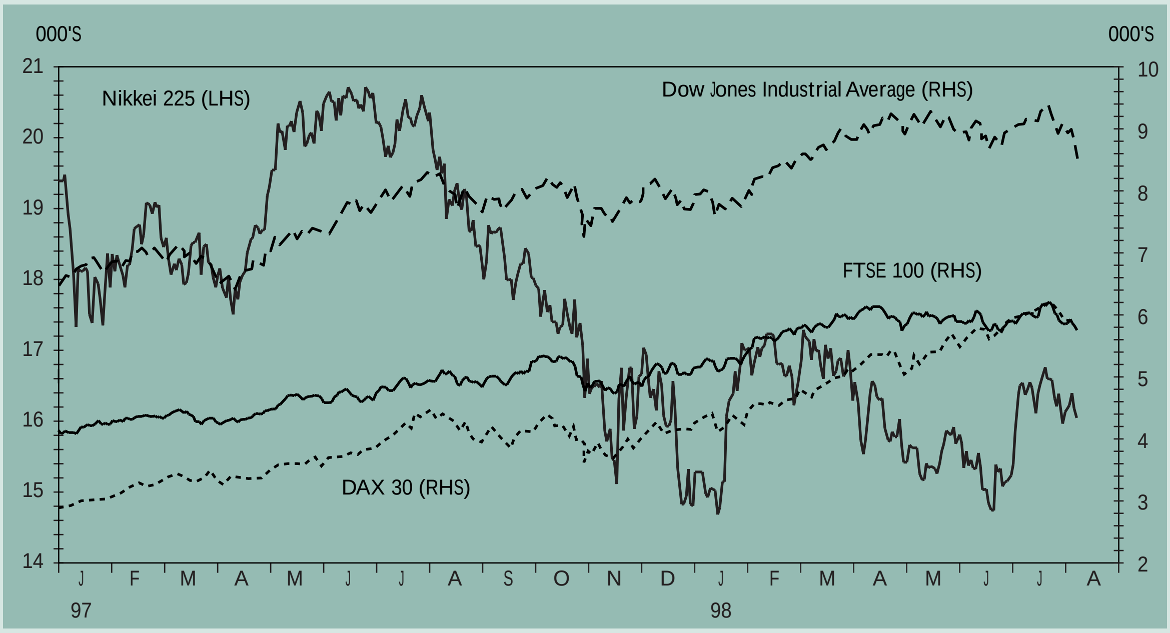
Financial Markets

Favorable price and growth prospects have continued to support bond and equity markets in the US and Europe. US treasury yields fell to historic low levels, while US and European equities repeatedly scaled record highs in the recent months (Chart 2). Concerns about Asia's negative impact and Fed warnings have prompted occasional corrections, but have yet to temper the bullish sentiment in a significant way.

In the currency market, the US dollar's strength remains largely unchanged, especially against the Japanese yen. Pessimism over the Japan economy, the world's second largest, persists as the

Chart 2

Stock Market Performance of US, Japan, UK and Germany



Source: DATASTREAM

government's repeated efforts to galvanize it with measures such as public works spending, tax cuts and deregulation have so far failed to deliver desired results. In mid-June, the yen fell to an eight-year low of 146.78 against the US$. Although the joint-intervention by the US Fed and the Bank of Japan two days later propped up the yen to 133.6, the turnaround was short-lived and the yen has fluctuated between 140-145 since then.

In the May-July period, the Russian rouble also came under heavy selling pressure. The rouble has remained broadly stable against the US$ but capital outflows led to steep increases in interest rates in Russia. The announcement of a US$11.2 billion IMF package in mid-July helped to restore stability to the Russian financial market.

Asia

The Asian economic downturn caused by financial crisis was more damaging and protracted than what many expected. The region's surprisingly poor performance in Q1 1998 was reflected in the

Table 1

Real GDP Growth of Selected Crisis-hit Economies in the First Quarter of 1998[1]

	Real GDP growth (% yoy)
Indonesia	-7.9
Malaysia	-1.8
Philippines	1.7
Singapore[2]	5.6
South Korea	-3.9

1 For Thailand, only yearly GDP figures are available.

2 On a seasonally-adjusted annualised basis, real GDP actually fell 1.4% in the quarter.

very sharp decline in GDP growth (see Table 1). Further deterioration is expected in the remaining quarters with consensus GDP forecasts being revised downward sharply (Table 2).

While most Q2 data are not yet released, anecdotal evidence and casual observations all point to continued and deepened damage. Bankruptcies and layoffs continue to increase. Bank credit contracted and corporate earnings fell sharply. In sum, there are few signs of an early recovery. For the region as a whole, the relatively brighter spot, perhaps, is the sharp improvement in the balance of trade. This, however, was a result more of import compression than export growth.

As the economy slid into recession, the widened output gap put downward pressure on inflation. Offsetting this pressure, however, was the effect of currency depreciation that increased the prices of imports and domestically produced import-competing products. In the countries where the exchange rate has become relatively more stable since the beginning of the year, the inflationary pressure caused by earlier currency falls has tended to ease. While most of the earlier depreciation is still expected to feed through over the course of 1998, the consensus outlook has improved somewhat in the past few months. The outlook for Indonesia remains an exception.

Looking forward, recovery will take time as the region is undergoing deep-seated structural reforms in the banking and corporate sectors. Prospects of recovery are further clouded by the weakness in the Japanese economy and volatility in the yen-dollar rate.

Table 2
Consensus Forecasts of Growth and Inflation for 1998

	Real GDP (% yoy)		**Consumer Prices (% yoy)**	
Survey Date	14 April	13 July	14 April	13 July
Indonesia	-6.3	-15.1	45.9	73.4
Malaysia	1.1	-2.6	8.1	7.6
Philippines	2.2	2.1	11.2	10.0
Singapore	2.7	0.4	2.4	1.3
South Korea	-1.6	-4.3	10.2	9.2
Thailand	-4.1	-7.2	11.6	10.4
Northeast Asia[1]	4.2	2.7	5.0	3.6
Southeast Asia[2]	-2.6	-7.4	21.4	30.1
North America[3]	2.8	3.3	1.8	1.7
Western Europe[4]	2.7	2.8	1.8	1.6

Source: *Asia Pacific Consensus Forecasts*, April and July issues.

1 China, Hong Kong, South Korea and Taiwan.
2 Indonesia, Malaysia, Singapore, Thailand and the Philippines.
3 United States and Canada.
4 Germany, France, the United Kingdom, Italy, Austria, Belgium, Denmark, Finland, Greece, Ireland, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland.

The mainland Chinese economy

The Economy

The Chinese economy grew by 7% in the first half. During the second quarter, domestic demand buoyed by an increase in fixed asset investment seemed to have picked up slightly but the external sector had deteriorated as export growth was affected by reduced demand from Asia. Poor weather and flooding resulted in an 11% drop in summer crop output in the second quarter. The heavy flooding of the Yangtze River is estimated to have trimmed second quarter GDP growth by 0.4 of a percentage point. Damages caused by China's biggest flood since 1954 continued into the third quarter.

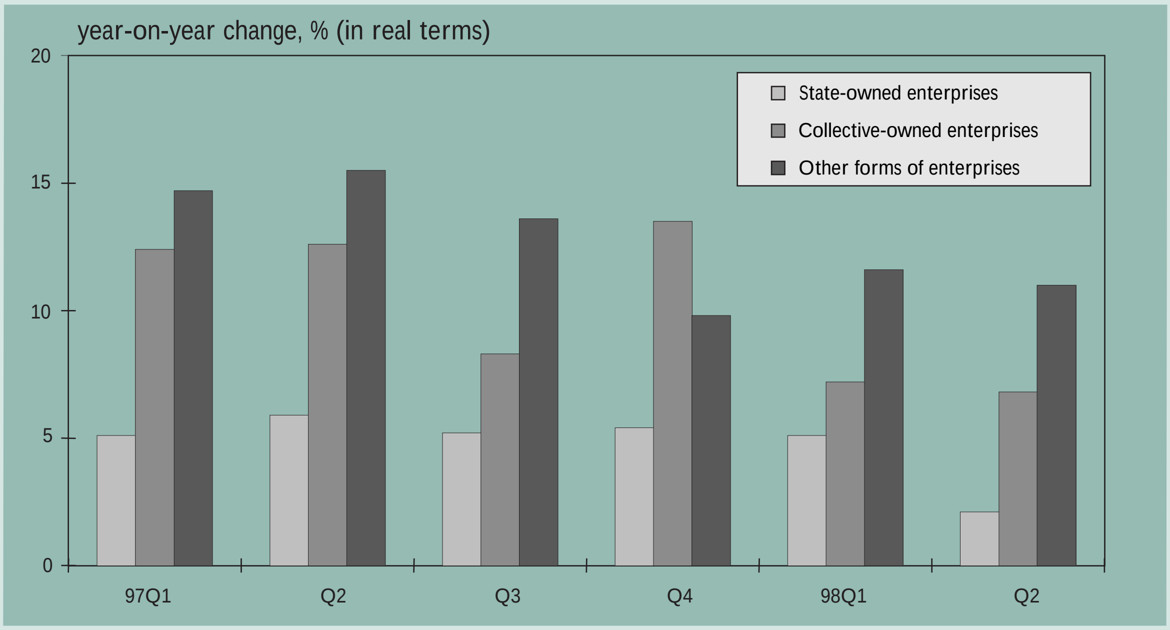
The policy to stimulate domestic demand through an increase in investment started to bear fruit. Growth in fixed asset investment accelerated to 15% during the second quarter, 4.7 percentage points higher than that in the first quarter. Investment in priority sectors such as transportation, postal and telecommunication services registered a rapid growth of 32.4% and that in agriculture went up by 16.1%.

To finance growth in investments, the government plans to issue additional treasury bonds amounting to RMB100 billion. At the same time, the authorities also encourage banks to increase lending by RMB100 billion to support investment in agricultural infrastructure, railway and telecommunications projects.

Domestic consumption, which accounts for 60% of GDP, continued to be weak. The growth in retail sales value during the first six months was 6.8%, compared with 6.9% in the first quarter. However, given a much faster decline in retail prices in the second quarter, -2.6% against -1.5% in the first quarter, retail sales volume actually increased faster during the second quarter. Adjusted for price changes, sales in real terms grew by 9.1% in the first half compared with 8.5% in the first quarter, a sign that could be regarded as a mild pickup.

The June retail sales figures were also helped by the sales of air conditioners and electric fans to meet demand stemming from the heat wave that swept across eastern China this summer. The pick up in consumption may be affected in the third quarter as consumer spending in provinces along

Industrial Value-added by Different Types of Ownerships



the Yangtze River[1] would likely be dampened by the heavy floods.

On production, growth of industrial output continued to slow. Industrial value-added grew by 7.7% in the second quarter, down half a percentage point from the first quarter. Valued added for state firms rose by 3.6%; that of collective enterprises by 7% while that of shareholding firms, overseas-funded companies and firms under other types of ownership by 11.3%[2].

The poor performance of the state-owned enterprises (SOEs) reflected in part their ongoing restructuring. SOEs are facing tighter financial constraints as banks are increasingly reluctant to lend to loss-making enterprises. In the first half, state-owned industrial enterprises together made a net loss of RMB9.3 billion.

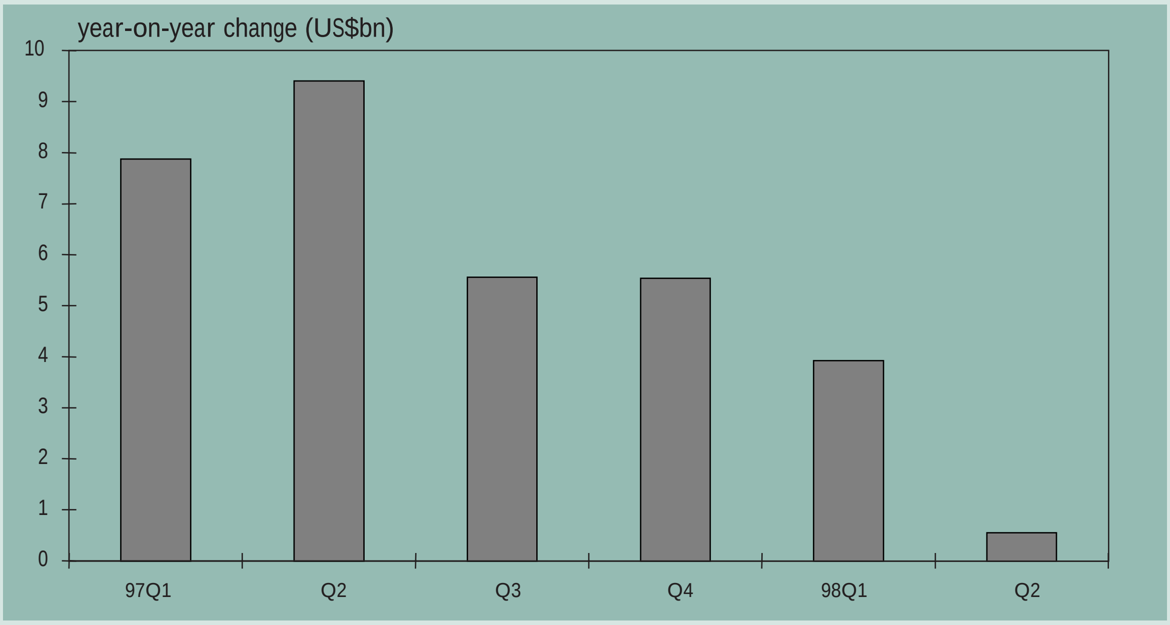
External Sector

During the second quarter, export growth moderated substantially to 3.0% from 13.2% in the first quarter. Over half of China's exports are destined for Asia. Reduced demand and direct investment inflows from the region have affected China's export growth. During the second quarter, exports to Japan, which used to account for a quarter of total, fell by 7.5%. Exports to Korea plummeted by 36.1% and those to and the ASEAN economies declined by 20.9%.

China's exports to US and Europe continued to register robust growth, a sign that Chinese exports are able to maintain their competitiveness despite sharp depreciation in the regional currencies. Exports to US and Europe grew by 14.5% and 19.4% respectively.

The contribution of net exports to the mainland GDP growth fell markedly in the second quarter. Although the mainland registered a respectable trade surplus of US$11.9 billion, it was about the same level of US$11.4 billion recorded during the same period last year. This was in sharp contrast to a 58% year-on-year increase in the first quarter. To encourage exports, the authorities have implemented various policies such as raising the degree of value added tax rebates for

Change in Net Exports



1 Provinces and municipalities that are mostly threatened by the Yangtze flooding include Hubei, Hunan, Jiangxi, Anhui, Jiangsu, Shanghai, Chongqing, and Sichuan.
2 These data should be interpreted with caution because many better performed state enterprises have converted to share-holding companies and no longer reported under the 'state sector'.

exports[3], strengthening trade credits, and relaxing the restrictions on exports of nonferrous metals.

Foreign Direct Investment

In the first half of 1998, foreign direct investment inflows fell by 1.3% from a year ago to US$20.5 billion but those agreed under contracts rose 5.5%. During the period, investment from Asia, which used to account for more than 70% of the total, moderated substantially although the decline was largely offset by increased interest from the US and Europe[4]. The mainland authorities have been putting in place a number of policy levers to attract foreign investment, including:

- introduction of preferential tax treatment for imported equipment and for projects in priority industries as well as projects in the interior
- removal of unreasonable fees and charges collected by local authorities
- simplification of project approval procedures
- expansion of new services industries, such as wholesale, retail, tourism and other business services for foreign participation

Foreign exchange reserves

The mainland's foreign exchange reserves declined slightly in the second quarter to US$140.5 billion at end-June compared with US$140.9 billion at end-March. This was partly because enterprises are now allowed to retain 15% of their export earnings instead of selling all of them to the state. This is reflected in a faster growth in net foreign assets held by Chinese commercial banks, while state foreign exchange reserves are not growing as fast. In the first quarter of 1998, net foreign assets of banks in China rose by US$5.7 billion, following an increase of US$3.4 billion in the fourth quarter of 1997.

Consumer prices

Both consumer prices and retail prices remained subdued, falling by 1.3% and 3.0% year-on-year respectively in June. The on-going restructuring of the state sector and import liberalisation have intensified competition in the consumer market. Excess supply of goods helps limit inflation. On the demand side, rising unemployment as a result of state-owned enterprises restructuring is limiting consumer demand. However, the heavy flooding along the Yangtze River has substantially damaged agricultural production along the region and this may exert some upward pressure on grain prices in coming months.

Monetary policy

Money supply growth continued to moderate. At the end of June, M0, M1 and M2 were up 6.6%, 8.7% and 14% respectively over the last year. The growth rates were slower than their corresponding rates of 9.9%, 11.8% and 15.4% at end-March. To help ease the interest burden of enterprises and to stimulate economic growth, the People's Bank of China (PBoC) further reduced interest rates on 1 July (Table x). The move was China's fifth cut since May 1996.

The latest round of interest rate cut has three major implications to the development of the economy and the banking sector. First, the reduction in loans for fixed investment is greater than that of other loans and deposits, signalling an intention to encourage such investments. Second, the reduction on interest rate on reserve deposits placed with the central bank is remarkable, a move that hopefully would encourage commercial banks

[3] In order to encourage exports, the mainland authorities has raised the degree of VAT rebates for exports three times since the beginning of 1998. Products that enjoyed higher rebates in the first two rounds included textiles, coal, steel products, cement and ships. On 1 July, the rebates for 12 categories of export items were raised to 11 per cent from 9 per cent. The items include seven kinds of electronics products (telecommunications equipment, power generation and transmission equipment, data-processing equipment, high-quality electrical appliances, farm machinery, aircraft and aviation equipment, and car and motor cycle components) and five types of light-industrial goods (bicycles, watches, photographic equipment, shoes and china products)

[4] Notable investment projects from the US and Europe announced in the first half of 1998 include: a US$4.5 billion petrochemical project by the Royal Dutch Shell Group; a US$1billion project by Eastman Kodak; a US$1.3 billion stainless-steel plant in Shanghai by Krupp Steel of Germany. Motorola also announced its US$1.5 billion expansion plan for its Tianjin factory.

to lend. Third, the average reduction in lending rates is greater than that of deposit rates, implying that interest margin and hence profitability of commercial banks would be further squeezed. To partially offset this, the PBoC also lowered its loan rate to financial institutions.

To further stimulate economic growth, the PBoC, together with State Economic and Trade Commission and the State Administration of Taxation jointly issued a notice calling banks to increase "closed loans" to loss-making state companies with marketable products and export orders[5].

Implication for Hong Kong

The second half of 1998 will remain very challenging for the mainland. Deterioration in the external sector is likely to continue and in the short term, Hong Kong's re-exports to and from the mainland would also slow down. In the medium term, efforts to accelerate restructuring of the state sector and further liberalisation of foreign investment, especially in the services sectors would provide ample opportunities to Hong Kong investors and professionals. Hong Kong has comparative advantage in services sector skills such as management, telecommunications, finance, legal, accounting and other business supporting services. Both Hong Kong and the mainland will mutually benefit from such developments.

5 The "closed loans" are to be granted through a special account and cannot be used for repaying other outstanding obligations (taxes, fees, wages or loans). Enterprises using these "closed loan" have to establish rigorous practical methods to convert losses to profits, and they must first repay these "closed loans" before undertaking any other steps associated with the longer-term process of "converting losses to profits".

Table x: Interest rates in China

	Effective 1 May 96	Effective 23 Aug 96		Effective 23 Oct 97		Effective 25 Mar 98		Effective 1 Jul 98	
Central bank loan rates to financial institutions									
20 days	9.00	9.00	(0.00)	8.55	-(0.45)	6.39	-(2.16)	5.22	-(1.17)
3 months	10.08	9.72	-(0.36)	8.82	-(0.90)	6.84	-(1.98)	5.49	-(1.35)
6 months	10.17	10.17	(0.00)	9.09	-(1.08)	7.02	-(2.07)	5.58	-(1.44)
1 year	10.98	10.62	-(0.36)	9.36	-(1.26)	7.92	-(1.44)	5.67	-(2.25)
Base interest rates of central bank									
Required reserves	8.82	8.28	-(0.54)	7.56	-(0.72)	5.22	-(2.34)	3.51	-(1.71)
Excess reserves	8.82	7.92	-(0.90)	7.02	-(0.90)	5.22	-(1.80)	NA	NA
Working capital loan rates									
6 months	9.72	9.18	-(0.54)	7.65	-(1.53)	7.02	-(0.63)	6.57	-(0.45)
1 year	10.98	10.08	-(0.90)	8.64	-(1.44)	7.92	-(0.72)	6.93	-(0.99)
Fixed asset investment loan rates									
1 to 3 year	13.14	10.98	-(2.16)	9.36	-(1.62)	9.00	-(0.36)	7.11	-(1.89)
3 to 5 year	14.94	11.70	-(3.24)	9.90	-(1.80)	9.72	-(0.18)	7.65	-(2.07)
5 year or longer	15.12	12.42	-(2.70)	10.53	-(1.89)	10.35	-(0.18)	8.01	-(2.34)
Deposits									
Demand deposits	2.97	1.98	-(0.99)	1.71	-(0.27)	1.71	(0.00)	1.44	-(0.27)
Time deposits									
3 months	4.86	3.33	-(1.53)	2.88	-(0.45)	2.88	(0.00)	2.79	-(0.09)
6 months	7.20	5.40	-(1.80)	4.14	-(1.26)	4.14	(0.00)	3.96	-(0.18)
1 year	9.18	7.47	-(1.71)	5.67	-(1.80)	5.22	-(0.45)	4.77	-(0.45)
2 year	9.90	7.92	-(1.98)	5.94	-(1.98)	5.58	-(0.36)	4.86	-(0.72)
3 year	10.80	8.28	-(2.52)	6.21	-(2.07)	6.21	(0.00)	4.95	-(1.26)
5 year	12.06	9.00	-(3.06)	6.66	-(2.34)	6.66	(0.00)	5.22	-(1.44)

Note: *Bracketed figures represent the magnitude of the cut.*